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## January 2011: Avoiding Complexity as a Bankable Strategy

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One of the great advantages that investors have is the ability to say “no.” With hundreds of thousands of investments offered every day (individual and pooled, structured and packaged, private and public, real and financial, leveraged and unleveraged, senior and junior claims), only a small minority are worthy of participation. Of all the choices, the best long-term investments are usually those that are the most transparent and least complex.

The investment industry has done a brilliant job of convincing the public that successful investing is a highly complex endeavor – that it requires prestigious credentials and superhuman math skills. This is, of course, absurd. While successful investing *does* require knowledge of finance, accounting and economics, an even temper and global and political awareness, *it is not rocket science*. Investing is an imprecise activity that takes patience, humility and good judgment. A successful investor also needs to recognize that people and entities promoting investments will spin their pitch to highlight upsides and de-emphasize any shortcomings. Those pitches often involve complex products with high fees.

Rarely does a day go by that I don’t get multiple sales calls about a “unique” or “new” investment offering. Skeptic that I am, I ask myself, “Why are *we* so lucky to have this opportunity put before us?” Many of the calls we receive are on investments that *need to be sold* because they carry a high level of complexity and need a salesperson to describe their merits. We generally don’t participate in these discussions as complex or structured investments are designed to help the seller, not to help our clients. To us, complexity is equivalent to obfuscation and allows devious people to do bad things at your expense. We can go down the list on the number of times complexity and/or a lack of transparency resulted in significant losses (or at a bare minimum, huge opportunity costs):

1. CDOs, CLOs and CDO<sup>2</sup>s – just try reading a prospectus...no wonder no one wanted them when liquidity dried up
2. Enron – had an incomprehensible cash flow statement that obscured a terrible business
3. The late-90s technology stock craze with its complex business structures and convoluted stock option grant programs – the only people to emerge victorious were the insiders
4. Quantitative Funds – the idea that math PhDs with complex mathematical models could generate outsized returns with lower risk. It failed.
5. Large supra-national investment firms, i.e., Lehman Brothers and Citigroup – their unanalyzable, overleveraged balance sheets and overpaid executives nearly destroyed the global financial system
6. Fannie Mae/Freddie Mac – blew up due to extreme leverage on low quality assets, political interference, and an inability to release financial statements for years

7. The level of interconnectedness and counterparty arrangements of major banks – total opacity handcuffed politicians and forced a taxpayer bailout of the entire financial system
8. General Electric and cookie jar accounting – investors overpaid for earnings stability and were exposed to high leverage using huge amounts of short-term funding
9. “Principal guaranteed” investments – exploited the risk-averse and gave them illiquidity, high fees and dead money
10. Insurance products sold as investments – illiquidity, high fees and poor performance
11. Long-Term Capital Management (the most ironic name in investment history) – Nobel Laureates demonstrating what economic theory looks like when put into practice with leverage
12. Bernie Madoff’s “proprietary” trading – enough said

All of the above are cautionary tales. All involve high levels of complexity and are (were) run by bright people. But intelligence itself will destroy value when the sponsor, promoter or issuer of an investment acts with self-interest and intends to obfuscate risk with complexity. Beware of investments promoted as being appealing because they’re run by “smart guys.” Smart guys or girls are a good thing, but only if they’re your advocate, not when they have the opportunity to mislead or cover-up through complexity.

As a general rule, if you are considering an investment with a 400 page prospectus, put the document down and walk away. A thick prospectus means more disclosures, greater complexity, more risks and more potential conflicts. We advise caution.

Caution is also advised for structured products. These instruments are designed by banking firms’ product specialists who nicely bundle listed (or over-the-counter) securities, options or futures – and slap a huge upfront fee on it. If the future does not unfold in a way that benefits the specific product’s design, the investor will be worse off and saddled with an illiquid, costly investment.

Simple is better. The investment world is challenging enough without unnecessarily committing capital to complex instruments, securities or pools. Investing is about understanding the nature of a claim on an asset that derives its value based on its uniqueness and its ability to generate future cash flow. Equally important is the ability to understand the elements of an asset’s value and how sustainable they are, be that asset a business, a brand, a resource, a platform, intellectual property or a series of future cashflows.

There is no formula, black-box, magic bullet, person, commentator, firm, algorithm, computer, fund, product, or process that will give great investment results all the time. An independent, unbiased, thorough investment approach – coupled with some patience is the best anyone can do and will yield good results over time. If anyone tries to convince you otherwise, just smile and say “no”.

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